Alternative credit focus:

A NEW POINT OF VIEW

A genuine alternative

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A genuine alternative

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WRITTEN BY ALISON SWONNELL, DIRECTOR OF FUND OPERATIONS, LCM PARTNERS

The Encyclopedia Britannica defines storm as "a generic term, which is popularly used to describe a large variety of atmospheric disturbances". This certainly seems a fitting description for the European pensions landscape, which has experienced a series of cyclones since the tech bubble explosion of the early noughties. Fifteen years on and, whilst we may have passed through the eye of the storm, balmy sun filled days feel like a distant memory to many pension schemes.

The tech storm exposed the risks inherent in equities with the Nasdaq Composite losing 78 per cent of value from its 2000 peak to the trough in 2002. At that time, with many pension funds invested in so called 'balanced portfolios', holding 60 per cent or more in equities, the industry quickly revised its view on what 'balanced' actually meant. This led to the genesis of liability driven investment solutions (LDI), which sought to more closely match assets with liabilities.

By 2008 LDI had arguably hit the mainstream, but once again financial 'mother nature' bit back, with the collapse of Lehman Brothers and the global financial crisis. This time derivative and bond-based solutions were squarely centre stage for pension funds. So successful have these strategies been that Mercer's *European Asset Allocation Survey 2015* states bonds are now the single

largest asset class within UK pension portfolios, accounting for 48 per cent, with equities 33 per cent. This trend is borne out across Europe with countries such as the Netherlands holding bond allocations of 55 per cent or more. Barclays research shows that fixed income inflows have grown by $1.2 trillion since the crash. Such has been the thirst for bonds that, at the point of highest demand, bond trading turnover decreased by 40 per cent. The gap between supply and demand is stark. Overlay this with a steady decline in bond yields over the period (10 year AAA yields fell from 3.1 per cent to below 0.6 per cent in the five years from November 2010 to 2015) and the latest storm clouds look darker still.

So once again, the industry finds itself caught in a perfect storm; one where more closely matched asset and liability solutions have been implemented, but at a point where bond supply has decreased and yields have become suppressed. With the low cost of corporate debt increasing the magnitude of pension liabilities, asset managers are once again innovating: offering alternative credit products with sustained yields and strong levels of absolute return.

Alternative credit, and in particular private debt, has grown significantly since the financial crash because it is a genuine alternative to fixed income and has stood up to yield depression. Preqin estimates $191.7 billion of dry powder is available today for investment in these funds. This is 4.5x the amount of demand seen a decade ago, making this one of the fastest growing alternative asset classes.

A boom in loan supply for specialist credit funds

Since the financial crisis, European banks have been dealt a continual stream of new rules and regulations. Together these pressure the banks to reduce the size of their balance sheet in an attempt to stay in line with new and increasing capital requirements. With banks offering non-performing loans (NPLs) and performing loans (PLs) for sale as well as scaling back new lending, asset managers have seized the opportunity to step into the gap and offer credit funds.

Divestment of portfolios and non-core business lines enable banks to comply with these capital requirements in an attempt to rectify historical capital deficiencies and meet increased future requirements.

The need to improve return on equity through focus on higher contributing assets and the realisation of operational efficiencies, alongside the regulatory pressures over use of capital, mean that the desire to sell these portfolios is increasing: the IMF first estimated in 2012 that European banks would need to cut their balance sheets by around €2 trillion, largely through the disposal of non-core assets (NPLs and PLs). This has since resulted in year-on-year increases in portfolios available for purchase, with more than €150 billion worth expected to be traded in 2015.

IMF director of the Monetary and Capital Markets Department Jose Vinals recently pointed to these problem loans being the greatest impediment to growth in Europe, saying that the banks must take "decisive action" to tackle the €900 billion worth of NPLs on their books. Furthermore, the recent publication of the European Banking Authority's *EU Wide Transparency Report* revealed the scale of the issue that banks still have to deal with: The European NPL ratio is double that of the US and stock stands at an even higher figure of €1 trillion (7.3 per cent of GDP): 6 per cent of European bank loans are impaired versus 3 per cent in the US.

The supply side pressures are unambiguous and will only continue to build over the next five years as banks scramble to adopt the Basel III capital accord and the IFRS 9 loan loss provision accounting standard, amongst others.

Pension demand

Preqin estimates that two out of three institutional investors are considering investing in private debt. With spreads forecasted to remain tight, buying wholesale credit portfolios in the form of private debt alternative investment funds offers pension schemes a true alternative to corporate and government bonds:

1) High levels of absolute return: a consistent 12-14 per cent unlevered yield can be achieved through building a portfolio of NPLs and PLs;

2) Liquidity: investments pay cash from day one and quickly amortise with capital typically returned within three to four years. So even if offered in closed end fund format, they are not illiquid in the same way that a private equity fund can be;

3) Low relative risk: more granular non-corporate credits can spread risk across many thousands of underlying borrowers, which result in low correlations to other asset classes,

4) Control over portfolio performance with limited tail risk: Buying impaired or non-core loans in the primary market and then improving the cash flow profile through loan servicing means that the manager can actively control returns, for example being able to react to correct underperformance. The strategy creates lower risk assets with established track records of payment, which means that the value left in the tail can be readily sold into the market at a premium;

5) Transparency: buying loan portfolios in a wholesale format offers investors greater transparency and look through to the underlying assets. This provides good visibility over the composition and performance of the assets, and coupled with the control aspect, is in stark contrast to buying a securitised product, which may well be investing in exactly the same underlying assets. Such transparency also creates a favourable Solvency II treatment.

Realising the credit opportunity

With the evidence for supply and demand clear, how can pension schemes invest in this privately traded asset class for whole loans?

Despite the fixed income style characteristics of buying whole loans, traditional fixed income asset managers do not typically have the skillsets able to realise this opportunity. Private debt expertise has emerged out of long-term commercial market participants, like LCM Partners who started investing in consumer and SME receivables 16 years ago, or via new entrants that have moved into the marketplace out of the banking sector: Typically former prop desk traders from investment banks, loan managers from commercial banks or via PE houses that have moved into private debt as an expansion of their product offering. Universal to all however is the transaction expertise required to source, underwrite and close deals.

Expertise and experience are of course the fundamentals to the evaluation of any potential investment manager, but in private debt and, more specifically, the purchase of whole loans, LCM would encourage investors to consider three things in selecting the right partner:

1) Sourcing ability: to identify sufficient, attractively priced transactions;

2) Underwriting expertise: a track record of delivering returns across the cycle;

3) Implementation experience: successful onboarding and servicing of a range of portfolios across markets and underlying product types.

With these three components evaluated, institutional investors can be confident that their manager is well positioned to deliver the double digit returns and yields still available in this part of the credit market, which should outshine bonds for the foreseeable future; from wherever the next storm clouds decide to blow. ■

INVESTMENT

Introducing private debt

Sandra Haurant explores how private debt, long popular with North American pension funds, is gaining traction with European pension fund investors

WRITTEN BY SANDRA HAURANT, A FREELANCE JOURNALIST

The pension fund industry has long been involved in lending money in return for steady income. Corporate and government bonds and asset-backed securities (ABS) and more have allowed them to seek out yield by offering credit through an enormously wide variety of avenues. Now, though, a shift in approach is encouraging schemes to look again at the way in which credit fits into their portfolios.

Private debt, a long standing element in North American pension landscapes, may not yet have built up a long history in Europe, but it is making a name for itself. It is a simple concept, says LCM Partners CEO Paul Burdell, and one that is attractive, particularly in a low interest current climate. "Private debt is nothing other than granting debt to counter parties," says Burdell. "In fact, pensions have been investing in credit through the ABS sector for many years. The difference with private debt is the originator."

Credit history

The ABS sector offers pension funds and institutional investors the oppor-tunity to invest in credit such as mortgages and credit cards through the banks, earning a regular income as a result. Seen for a time as an efficient means of investing in credit for pension funds, the credit crisis of 2008, in which US sub-prime mortgages played such an important part, took the shine off this sector, although it has been seeing more enthusiasm in recent times.

M&G Investments announced in October 2015 that it had raised some €1.5 billion for a range of European ABS strategies, with the bulk of capital coming from pension funds in the UK, Netherlands and Nordic countries, looking for yields and security in today's low interest environment through investing in these pools of assets, which can include consumer loans, residential and commercial mortgages and commercial loans.

M&G ABS portfolio manager James King said: "ABS has typically been under-represented in an institutional investor's portfolio but following the resilience of the asset class in Europe during the wake of the financial crisis, we are seeing an uptick in investors wanting to understand more about the role ABS can play."

But while ABS offers one way into the credit market, many argue that a more direct approach can be more successful, and that developments in the credit market since the financial crisis are leading to a more attractive environment for direct lending.

Mind the gap

Part of the shift is due to renewed thinking in the wake of the financial crisis. Europe has, through necessity, moved away somewhat from its previous dependence on banks as primary lenders and this has left behind a gap to be filled. But Europe still needs credit, so where is it to come from? As a report into the private debt market published by StepStone says: "This capital is increasingly provided by pension funds and insurance companies via private credit funds, predominantly populated by former bankers, hedge fund and private equity professionals."

Towers Watson head of illiquid credit Gregg Disdale confirms appetite is real on both sides: "We have seen most demand [from pension funds] in the direct lending area. A lot of people have bought into the migration from banks being primary lender to middle market corporates in Europe, to a point where more private capital is needed alongside those banks. Banks have much greater capital requirements, with the result being a retrenchment in corporate lending. It is therefore an obvious area for pensions to be considering stepping into," says Disdale. "This is also driven, of course, by the fact that asset managers saw the opportunity and started to raise funds to take advantage of it," he adds.

Disdale is also starting to see pensions consider real estate and infrastructure debt, he says, commenting: "They are stepping in where banks have been somewhat less able to lend than they were pre-crisis, given the size of their legacy books. In both of those areas, however, banks have come back and are stronger than they were expected to be. But the trend of greater institutional investor participation is still there, medium to long term."

Private debt is an area that is relatively new for Europe, and has not yet had time to prove its worth, explains StepStone senior adviser John Bohill. "This is a very nascent credit market; it's only really since the downturn that it has existed so there are inherent risks with that, which means it will take a little while [to build a track record], but the market is starting to mature and managers are starting to show performance," he says.

By contrast, North America has built up a real history in this space, one which can be used to understand performance through a variety of investment environments, from the more benign to the downright hostile. "In the US, which has been used to a non-banking dominated market for a much longer period, you can actually look at the success or otherwise of private credit as a strategy," explains Bohill.

With this track record in place, StepStone has looked at a manager who has been operating for more than 10 years in the US, with a substantial amount of loans given to the mid market. Bohill says: "We tracked the performance of those loans through the global financial crisis and beyond, and we compared the performance of that portfolio against public equity, real estate and distressed investing, and what we found was that the correction was much less extreme. It was a much less volatile investment in that period, while public equities obviously had a huge increase and a massive correction. It showed itself to be dependable, not very highly correlated to other areas of a portfolio, and we found it to be a strong product."

A large part of the appeal for pension funds turning to private debt is just that: the dependable, regular income with reasonable yield, hard to come by in today's low interest environment. But their transparency is also a major boon. The nature of these investments means that investors can see, and pick and choose, just who they decide to lend to. "There is a very high level of transparency in private debt," says Burdell. "You get the opportunity to look into each and every loan."

Disdale adds: "There are a few areas where people believe that, because you are engaged in bilateral negotiations in a lot of these private loans, you've actually get better credit protection than in syndicated credit markets." In an asset class where, in Europe at least, scope for access has opened up relatively recently, the fact that investors can peer in and see just what they are getting into appeals.

Slow and steady

Nonetheless, choosing the right way into the asset class remains key to successful investment in this area. "In the private equity world you get bonus points for picking new and interesting managers that have a niche because you're trying to generate absolute returns of between 20 per cent and 40 per cent internal rate of return (IRR). But in credit, what you are really looking for is managers who just go about their business day in, day out, with lots of deal flow, who turn lots of deals down. You don't get bonus points for outperformance, because you might have exposed yourself to significant risk in doing that. You need to look at diversification within a portfolio, how many loans are in there, what industries are they investing in and what leverage multiples are they lending at."

As the asset class develops and managers build on their experience, the role private debt plays within pension funds' portfolios is also evolving. Private debt might once have been found within the portfolio as an alternative to private equity, but, says Bohill, this is changing with pension funds increasingly switching from fixed income into private debt. And, as he says: "Fixed income portfolios are enormous, so the potential capital to be raised from those is substantial." ■